Financial reform and multi-level governance - a balancing act

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Abstract

Globalisation, rapid technological development and the information revolution are important international factors influencing the functioning of multi-level systems of government. Regional and local governments, especially cities, play an increasing international role. Cities compete internationally in various ways, whether it is to attract tourists, major conferences or hosting of major international sporting events such as the Olympic Games. How does this affect the domestic financial arrangements in multi-level systems? What impact does it have on governance in municipalities? Is the original constitutional framework still relevant, or should it be adapted to take the changing circumstances into account? In various multi-level systems of government constitutional, legal or administrative reform initiatives are debated and implemented in order to deal with domestic and international challenges.

After 20 years of democracy in South Africa there is a growing need to review and reform the financial intergovernmental relations system, in particular the funding of local government. Most of the municipalities in South Africa are struggling to function properly and to meet the constitutional standard for the delivery of services to their local communities. Building of more administrative capacity is taking place but is not enough. Local government financial reform cannot be done in isolation, but requires a careful consideration of the needs and interests of national and provincial government as well as the changing international environment and how that impact on all levels of government. Improvement of the financial governance within individual municipalities is part of the local government financial reform that is needed in South Africa. Competing interests might require a fine balancing act to enact financial reform to the benefit of all levels of government. Innovation in the delivery and financing of public services is necessary to transform municipalities in effective and efficient citizen centric institutions. This paper analyses the current challenges and opportunities for reform in South Africa.

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1. Introduction

One of the effects of globalization is that the world is much more connected in the 21st century compared to before 2000. The news of today in Cape Town is immediately available on the various media platforms and social media to anyone elsewhere in the world. Local issues can easily attract international attention. A local enterprise is not necessarily limited to the immediate local market, but could have an international footprint. This reality of living in a global community where information and communication technologies are key drivers have an impact on governance, including financial governance, in a country.

Local government, being the closest institution of government to the citizens, play an important role in any democracy. In multi-level systems of government the position of local government vis-à-vis the other levels of government can vary from one country to another, but it remains an important institution of government responsible for delivery of services to local citizens. Within the European Union there is a strong focus on the role of local authorities in the member states as well as in the wider group of members of the Council of Europe. This is reflected inter alia in the international institutions and legal instruments created to strengthen the position of local authorities, e.g. the Congress of Local and Regional Authorities in Europe and the European Charter of Local Self-Government. In any system of government local authorities need appropriate funding to perform their constitutional and other legal obligations. Financial governance, including effective and efficient financial management of municipalities, is under the spotlight in many countries, in particular in the aftermath of the global financial crisis in 2008.

In South Africa local government was restructured a few years after the establishment of constitutional democracy in South Africa in 1994. This was a massive exercise that involved amalgamations of previous administrations, the establishment of new administrations and democratic elections for municipalities throughout the country. The building of sufficient and appropriate administrative capacity in all municipalities was a major challenge and remains a challenge even after two decades of democratic local government. Local financial management is currently in the spotlight in view of the bad financial situation in most of the municipalities in South Africa. The Auditor-General reports annually on the state of financial management in municipalities and in the Consolidated general report on the audit outcomes of local government MFMA 2012-13 the poor state of local finances was again highlighted. The report indicated that there is reason to be concerned and that municipalities must improve their legal compliance, quality of financial statements and general financial management. In addition, the Financial and Fiscal Commission (FFC) also expressed its concern about the financial
viability of many municipalities. The poor performance of most municipalities in South Africa was scrutinised by the national government in 2014 and led to the introduction of a new program (Back to Basics Program) to strengthen institutional capacity and enhance service delivery in all the under-performing municipalities in the country. The nine provincial departments of local government also participate in this program in view of their constitutional role to monitor and support local government.

The international financial crisis in 2008 did not have such a huge impact in South Africa as it had in Europe, but it nevertheless had a negative impact on economic growth and it also affected local government since in many communities the economic slowdown contributed to a higher demand for social support and services to poor communities.

Local financial governance, including the current model of local finance, in South Africa is thus severely under pressure. It is against this background that this paper discusses some international developments that have an impact on local financial governance. It further focuses on the need for reform in South Africa and offers some suggestions for reform initiatives. The competing interests of national policy goals and local needs is inherent in multi-level systems of government and adds to the complexity of finding appropriate solutions to questions of financial reform. Some comparative references to developments in other multi-level systems of government will also be made in order to draw from the experience of others with a view to improve the situation in South Africa.

2. International developments

Globalisation has a significant impact on both developed and developing countries, although the effect varies between states. There are both positive and negative impacts on countries. Shah argues that the positive impact of globalisation on poverty alleviation combined with the information revolution act as catalysts for reshaping government functions both within countries as well as in an international context. These factors also have an impact on how local government functions – it leads to strengthening local government institutions as well as greater citizen empowerment in many countries and thus the creation of new opportunities for co-production of public services. This specific trend is often referred to as localisation which contributes to improving social and economic conditions in local communities. Some of the negative effects of globalization were visible in the aftermath of the international financial crisis of 2008, namely that many countries suffered periods of reduced economic growth or even economic stagnation that led to increased unemployment for example in Portugal and Spain.
Globalisation also has a significant impact on the tax regimes of countries. The growing mobility of people, information and capital often has a limiting effect on countries’ potential to collect personal income and corporate tax, thus reducing the available resources to fund public services. This means that countries must rethink their internal tax arrangements and funding allocations to different levels or spheres of government. In multi-level systems of government it could cause a new assessment of its financial equalization measures to ensure that poor local or provincial governments get appropriate financial support.

Various global issues create challenges for countries around the globe individually but also collectively. Climate change, the international financial and economic crisis in 2008, pandemics such as HIV/Aids and Ebola, and increasing pressure on food security, are some of the major global challenges that warrant attention of individual countries as well as international organizations. These global issues are debated at various international meetings, but it has a domestic dimension as well that warrants appropriate consideration within individual countries. Global issues often has an impact on the way government is structured and functioning in individual countries, thus also on the potential role of local governments. Governments could for example establish special task teams to deal with specific issues of this nature and allocate earmarked funding to address issues such as climate change or food security. Responses to international crises often include local solutions, for example local measures to limit the spread of Ebola in West Africa were part of the international response to the crisis. This confirms the interrelatedness of the global community of nations.

The low economic growth and increased unemployment in many countries, e.g. in Portugal and Greece, as a consequence of the international financial crisis also had a negative effect on the financial situation in many local governments. In such an economic climate it is not feasible to impose higher rates of local taxes or any additional taxes. Many municipalities thus found themselves in a difficult situation – it could not easily raise local taxes without harming the local community, but if they wanted to stimulate economic growth they had to provide tax incentives and this would reduce their tax income, thus limiting the ability of those municipalities to deliver services. In view of the impact the financial crisis had on many national governments in the European Union, transfer of funds to local governments in those countries also came under pressure, thus adding to the woes of many municipalities.

Urbanisation is a common phenomenon in many countries around the globe. In fact, most of the world population currently live in urban areas and urbanisation is increasing. More than 80% of the economic production in the world is generated in cities. It is expected that most of the future urban growth will be in Africa and Asia. Together with all the
pressure urbanisation brings on infrastructure and service delivery in local communities, there is often the additional pressure that poverty is increased in urban areas, which requires even more attention to the financial situation of local governments. Cities and towns continue to grow in numbers of inhabitants and must be equipped to deal with it, both financially as well as administratively.

In a recent study on decentralization done by the organisation United Cities and Local Governments it was stated that the growth in metropolitan areas in particular requires innovative governance solutions and appropriate fiscal architecture.\(^8\) Infrastructure development, whether it is for provision of basic services such as water, electricity and waste removal or the building of roads, schools, hospitals and creation of wi-fi and broadband connectivity requires significant funding sources. The growth in urbanisation adds to the growing backlog in the provision and maintenance of infrastructure in local communities. The increasing pressure on the financial situation in many local authorities in a variety of countries calls for a renewed focus on decentralisation, including financial decentralisation, in an attempt to develop innovative solutions for local communities. This is, however, a global issue and not only a South African issue. The international financial and economic crisis in 2008 had a negative impact on the ability of many local authorities to take care of infrastructure development simply because less funding was available for capital expenditure.

Despite all these negative impacts of the global financial and economic crisis on local government in many countries, there are also positive international developments in recent years. In a study by the Chamber of Local and Regional Authorities in Europe in 2014 it was reported that in Poland the reduction in national grants to local government led to strengthening of local tax revenue. In Macedonia the financial capacity of municipalities was strengthened through restructuring of local government finances in order to grow the local sources of revenue.\(^9\)

The speed and scope of technological developments, in particular in the field of information and communication technology (ICT), has a significant impact on governance and how government interact with the citizens. E-government at different stages of development is common in many countries. A recent trend, building on the popularity and usability of smart phones, is to use smart phone technology to improve governance, so-called M-government. How do governments, in particular local government respond to these developments? What are the budgetary implications for government if it wants to use mobile technology to interact with citizens? These and other related questions about the impact of ICT on local financial governance do not only relate to the financial resources of local authorities, but also to their functional responsibilities – how can they use technology to provide services more efficiently? The continuous advancement of ICT
also places new tools in the hands of the citizens to help shape the delivery of public services.

The economist, Anwar Shah, argued in a recent research paper that it is important for the prosperity and competitiveness of countries to embrace modern technology and to go a step further, namely to put citizens in the center as the principals of government services. The institutions of government are then the agents which provide the public services to the citizens. Accepting such an approach to public service delivery will also have an impact on local financial governance.

3. Local government in a crisis

Local government in South Africa was the last of the three spheres of government to be instituted after the adoption of the current Constitution in 1996.\textsuperscript{10} It took a few years to implement the legal framework, institutional restructuring and local government elections for the current system of local government. In terms of section 152 of the Constitution local government has clear objectives, namely:

(a) To provide democratic and accountable government for local communities;
(b) To ensure the provision of services to communities in a sustainable manner;
(c) To promote social and economic development;
(d) To promote a safe and healthy environment; and
(e) To encourage the involvement of communities and community organisations in the matters of local government.

After 20 years of constitutional democracy most of the municipalities in South Africa don’t live up to the constitutional expectations. Poor or no service delivery, lack of infrastructure maintenance and simply poor management are common in many municipalities in the country. Most of the 278 municipalities find themselves in a financial crisis. According to the \textit{Back to Basics Report} by the Department of Cooperative Government and Traditional Affairs only one third of the municipalities are currently delivering their constitutional mandate effectively with a small percentage of this top category that excels.\textsuperscript{11} These municipalities are mostly characterized by good financial governance, innovation and appropriate administrative and management capacity.

A big concern is the large number of municipalities that are either ‘fairly functional’ with ‘average performance’ or totally ‘dysfunctional’. Common features of the poor performing or dysfunctional municipalities are: poor or no service delivery, infrastructure problems, administrative incapacity, growing distance between political representatives and citizens and corruption in some cases. This assessment by the Department of Cooperative
Government and Traditional Affairs is confirmed by other reports from the Auditor General and the Financial and Fiscal Commission (FFC). In its report on the review of the local government fiscal framework (Sustaining Local Government Finances) in 2013 the FFC referred to the diverse performance situation in local government from well-performing municipalities at the one end of the spectrum to failure and collapse of service delivery in many small local municipalities at the other end. It is evident from this report that it is not only the structure of local government funding and questions about adequate funding sources that has an impact on the performance of local government, but there are also non-fiscal issues such as the need for appropriate and sufficient administrative, managerial and technical capacity in municipalities that contribute to the current poor state of local governance. The combination of a lack of capacity and a lack of funds is a recipe for failure.

The Auditor General indicated in its Consolidated general report on the audit outcomes of local government 2013-14 that although there is improvement in the quality of financial reporting there are still various primary issues in local financial governance which are problematic. Poor financial management, inadequate administrative and management capacity and the deteriorating financial position of many municipalities are some of the key concerns raised by the Auditor General. Infrastructure development and maintenance suffer in the poor performing municipalities since they underspend their capital budgets or they use their grant funding for other purposes than what it was designed for. This situation also contributes to poor or no service delivery and thus increasing dissatisfaction among the local citizens.

In terms of the current fiscal framework for local government most of the rural municipalities in the country don’t have sufficient own sources of revenue and are largely dependent on the equitable share allocations in accordance with section 214 of the Constitution and grant funding. Metropolitan municipalities and some local municipalities in other urban areas where there is a larger tax base are less dependent on transfer funding. Despite this varied profile of municipal own revenue, it should be noted that all municipalities include poor communities where no or very little municipal revenue is generated while they must still receive the spectrum of municipal services, thus compounding the problems relating to creating sufficient own revenue.

The FFC argued correctly that specific attention should be given to ensure that municipalities are financially viable and that various factors, including their demarcation, contributes to their financial viability. Unfortunately, various municipalities in particular the district municipalities are currently not financially viable. The district municipalities don’t have an own source of revenue, unless it has the responsibility for bulk services in the district for which it can collect user charges, but this does not necessarily mean they
are financially viable entities. In its 2015 submission on the division of revenue the FFC stated that the impact of demarcations on the fiscal position of municipalities should be evaluated in order to get improved municipal demarcations that will ensure financially viable municipalities.\textsuperscript{15} It concluded its analysis of a few case studies where demarcation of municipalities took place by recommending that economic considerations should be at the center of any demarcation decision.

The seriousness of the problems within local government is emphasized by the Back to Basics Report produced by the national Department of Cooperative Government and Traditional Affairs. It calls for a paradigm shift in local governance that will turn the current situation around and create well-performing responsive and accountable municipalities where sound financial management and sufficient administrative and management capacity is in place.\textsuperscript{16} In order to achieve this ambitious goal a concerted effort by politicians, officials and other role players in the academic and business environment is necessary.

It is evident that the current poor state of local government finances is a rather complex situation with various facets such as financial viability, administrative capacity and quality of financial management. It relates to the local government fiscal framework as well as to performance related issues in individual municipalities such as the effective collection of revenue, or the efficient provision of water and electricity services to inhabitants. This situation suggests substantial reform of the current system in order to get local government to the performance level anticipated by the Constitution. In various other countries local government financial reform processes are undertaken from time to time and are often required in order to adapt to changing circumstances.

4. Opportunities for reform

The starting point of any reform initiatives should be the Constitution due to the application of the principle of supremacy of the constitution and the rule of law. The Constitution provides a clear legal framework for government, including local government, to function and it further provides a sound base for the financial intergovernmental relations in South Africa. This constitutional legal framework has been complemented by the implementation of various laws on issues such as local government systems, financial management and the equitable division of revenue. The governmental system in South Africa is one of cooperative government and is governed by the principles of cooperative government and intergovernmental relations in Chapter 3 of the Constitution.\textsuperscript{17} What scope is there within this constitutional and legal framework for reform of local
government finances? What opportunities are there for reform in order to improve the local government finances and to get a better functioning system of local government?

According to the World Bank there are two important driving forces in the world of the 21st century, namely globalization and localization, also referred to as decentralization.\textsuperscript{18} These two forces are not contradictory but in fact complement each other. Decentralization can have both a political and a fiscal element. Fiscal decentralization refers to the division of expenditure responsibilities among the different spheres or levels of government and the concomitant funding arrangements to enable all the spheres of government to perform their constitutional functions. The economist Anwar Shah reiterates the World Bank view on the importance of globalization and decentralization and he goes further to argue that the 21st century requires a reshaping of local government to be citizen-centric, based on subsidiarity, outcomes driven, innovative and fiscally prudent.\textsuperscript{19} The role of local government in multi-level systems of government is changing and reform initiatives are taking place or should be considered in order to create sustainable local governance to the benefit of the citizens.

The objects of local government listed in section 152 of the Constitution contain clear goals to be achieved by all institutions of local government. It is phrased wide enough to create sufficient scope for different policies and initiatives to be developed to achieve those goals. There is thus no need to amend these objectives, but the question is rather what could be done to enable municipalities to achieve all those goals and to adopt the 21st century profile described aptly by Shah. Reform initiatives should take the listed objects as a point of departure.

In its review of the local government fiscal framework the FFC stated that a restructuring of the fiscal framework should allow for differentiation between urban and rural municipalities in view of their different economic, demographic and social profiles.\textsuperscript{20} An asymmetric approach that properly reflects the financial impact of the specific issues relating to growing urbanization in metropolitan areas, as well as the need to assist rural local municipalities to be sustainable is necessary. There are, however, some cases where the economic links between cities and the surrounding local areas are important for current and future developments and a more comprehensive view of the funding issues in those areas would then be necessary. Cities have the ability to raise more own revenue compared to small local municipalities where the economic potential is low. The funding arrangements should thus reflect this asymmetric situation.
Reform initiatives could be organizational, institutional or fiscal in nature. At the organizational level, which is within individual municipalities, the continuous building of appropriate capacity is an important building block. The Back to Basics program of the Department of Cooperative Government and Traditional Leaders is an initiative to give effect hereto. Organizational reform also means that municipalities will have to do more with less, which means that more cost effective delivery of services is required which will in turn create some space for enhancing support to the poor. Proper costing of services and obtaining and managing reliable consumer data are essential elements in strengthening the cost effectivity of municipalities. Local municipalities must therefore ensure the registration of all inhabitants or consumers of public services on their database and keep it up to date. Improving collection of own revenue and strengthening financial management will go a long way to ensure good governance in a municipality.

Institutional reform is about finding the most appropriate institutional arrangements within local government to meet the challenges of the 21st century. This could also have an effect on the division of functions between provinces and municipalities. Institutional reform must contribute to the shaping of financially viable municipalities. Geographical and functional demarcation is at the core of institutional reform. The role of district municipalities was rightly questioned by the FFC since it does not provide value for money. Two options could be considered, namely to abolish district municipalities, assign their functions to local municipalities and get agency and cooperation agreements between local municipalities inter se and between local municipalities and the respective provincial government for the delivery of services. An alternative would be to do a redesign of functional responsibilities of local and district municipalities together with the creation of an own source of revenue for district municipalities.

Fiscal reform is not necessarily about new or higher taxes, but is should rather focus on a reshaping and improving of the current taxes. It is in the interest of municipalities to maximize their fiscal capacity, which implies that they should regularly update their property data base, review their tax rates and improve the collection of local revenue. One area of potential fiscal reform is the position of district municipalities. If they are abolished, the funding allocated to them by the National Treasury would then be available to provide additional funding to the rest of local government. If, however, district municipalities are redesigned, proper functional and funding arrangements must be central to such a redesign. Some international examples of how funding for similar type of local authorities is designed could be considered. In Japan the two tier system of local government consists of prefectures (a type of district government) and local municipalities.
An important source of local tax revenue is a local income tax on all inhabitants and the revenue from this is divided between the local municipality and the prefecture. In Bavaria, Germany the general local government revenue (primarily a percentage of income tax and sales tax) is divided between the district municipalities (36%) and the local municipalities (64%). The district municipalities (Landkreise) also get an additional district income allocation based on the fiscal capacity of the local municipalities (Gemeinde) in that district.

Reform of local government finances is an important element of decentralization of government, which contributes to building sustainable and stable local authorities that could enhance economic and social development.

5. Balancing competing interests

Local government finance in a multi-level system of government cannot be viewed in isolation. It forms part of a comprehensive system of financial intergovernmental relations and amendments to one part would affect the rest of the system. Local government financial reform should thus also take into account the role of the other two spheres of government and reflect on the whole system of financial intergovernmental relations. The FFC suggests a 'whole of government response'. Such an inclusive approach to financial governance reform is an appropriate but complex exercise since there are various competing interests and it would require a fine balancing act in designing appropriate reform measures.

Inherent in multi-level systems of government are different national and sub-national interests that are balanced to an extent through the constitutional division of functions, but if there is an uneven division of financial resources a vertical fiscal gap is created. Various financial equalization mechanisms can be used to bridge the gap and assist the sub-national governments to perform their constitutional obligations. There are legitimate funding needs of provincial and local governments, including a degree of financial autonomy, based on their constitutional allocation of functions. At the same time there are legitimate national funding needs relating to the national government functions and the policy framework of the national government. Competing interests have an effect on the allocation of financial sources to the respective spheres of government. Finding the appropriate balance is not a once off exercise but is part of a continuous journey to balance competing needs and interests in an ever changing environment. In Germany and Belgium there have been regular debates and even court cases over many years about finding an equitable solution and it remains a topical issue.
Local government financial reform initiatives in South Africa can only be done in accordance with the rule of law and supremacy of the constitution. This means that the constitutional framework is the canvas on which the reform picture must be painted. Important principles such as accountability, transparency and subsidiarity underpin a well-defined public finance system in multi-level systems of government and are often contained in a constitution. Section 215 of the Constitution stipulates that budgets and budgetary processes in the national, provincial and local spheres of government must promote accountability and transparency. Section 214 of the Constitution determines that there must be an equitable division of nationally collected revenue. Reform initiatives must also be based on these and other applicable principles.

In line with the international trend of growing decentralization and based on various international studies Shah argues that citizen-centered governance should guide local financial reform. This means that citizens have different roles, namely as recipients of public services, taxpayers and co-creators of public services. Such an approach, according to Shah, is based on accountability, transparency, effective public participation and fiscal responsibility. These are all principles that promote good governance and should thus be supported. The economics Nobel Prize Laureate, Amartya Sen, argues that good governance is necessary for freedom and economic development, and thus the ultimate goal of improving the quality of life of citizens. These principles provides a solid basis for local financial reform, but is it enough to balance competing interests and needs in a multi-level system of government?

In the German Basic Law there is an important principle that guides the division of finances and spending of public funds in the country, namely ‘to ensure equal living conditions in the federal territory’. The practical application of this principle allows for different policy options that can also be amended over time, but it provides a common vision that applies to all spheres of government. It is an important tool that helps to find a workable balance between competing federal, Länder and local interests. Such a common vision contributes to the effective functioning of the financial intergovernmental relations system. The fact that it is contained in the Basic Law gives this principle a very high value and the application thereof transcends the different views and plans of political parties.

The scope of technological developments produced by the information technology revolution creates new opportunities for improving governance. It places new tools in the hands of consumers that can strengthen accountability and help citizens to co-design some public services. Utilising the input of citizens in different governance processes can
enhance the legitimacy of government and improve the effectiveness of the services it has to deliver. Innovation in governance processes and interaction with citizens is thus an important additional factor that must be taken into account in any local government financial reform initiatives.

Improvements in the funding arrangements of local government must be accompanied by strengthening the administrative and management capacity of municipalities in South Africa. At the same time it is important that provinces and the national government fulfil their monitoring and supervisory role more effectively in order to support local government. In accordance with Shah’s citizen-centered approach local governance reform will not only enhance the role of citizens, but it will also contribute to improving the administrative capacity in local authorities.

In conclusion, a comprehensive consideration of the composition and functioning of the financial intergovernmental relations system in South Africa within the constitutional framework is the appropriate basis for local financial reform. Reshaping the architecture of local finance has different elements but should be citizen-centered and must embrace the effective use of modern information and communication technology. Some legislative reform will be necessary when for example changes to the role of district municipalities are considered, but it must be part of a package of reform initiatives that also includes changes to the composition and functioning of the current revenue basket for local government and improving the cost-effectiveness of delivery of local public services. Such local financial reform is necessary to enable municipalities to properly fulfil their constitutional mandate and to be competitive and sustainable institutions of government in a fast developing world.

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